

BM Circular No. 1014

January 13, 2007

To: All Licensed Commercial Banks in the Sultanate of Oman

After Compliments,

**Sub: Guidelines on Management of Country and Transfer Risks**

Please refer to our letter No. BSD/2006/OBMU/Banks/441 dated April 15, 2006 enclosing therewith, draft regulations on country and transfer risks for comments of banks. The draft proposals have been revised, among other things, in the light of views/suggestions of banks. The final guidelines envisage an appropriate policy and operational framework for assessment and monitoring of country risk, which is provided hereunder for implementation by banks.

**Introduction:**

2. Cross-border exposures involve a number of risks. In addition to risks associated with the creditworthiness of counter parties, banks are exposed to other dimensions of risks - funding, interest rate, currency, settlement, etc., in cross-border exposures. Cross-border lending also involves country and transfer risk. *Country Risk* refers to the possibility of sovereign borrowers of a particular country being unable or unwilling, and other borrowers unable, to fulfil their foreign obligations for reasons beyond the usual risks which arise in relation to all types of lending. Such risks are associated with economic, social and political environments of the borrower's home country. Country risk is most apparent when lending to foreign governments or their agencies, since such lending is typically unsecured, but it is also important in respect of foreign loan or investment, whether to public or private borrowers. Sovereign risk arises from the special risk associated with a sovereign loan, which is a loan to, or guaranteed by a government (and some government-guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action, i.e., the borrower might claim immunity from process or might not abide by a judgment. *Transfer Risk*, on the other hand arises when a borrower's obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the borrowers regardless of their ability to meet the obligations or financial condition. Another element of country risk could be *Contagion Risk* which arises where an adverse development in one country leads to downgrade in rating or credit squeeze not only for that country

but also other countries in that region, notwithstanding that those countries may be more credit worthy and that the adverse developments do not apply to them.

3. The Central Bank is committed to adopt international best practices, codes and standards. Further, local banks in the context of globalization and integration, have been assuming cross-border exposures on an increasing scale. In this scenario, there is a heightened need for a specific framework that addresses the supervisory concerns associated with country exposures and in that direction the guidelines are issued.

#### **Policy framework for country risk exposures:**

4. Banks should have an appropriate policy framework approved by the Board of Directors for identifying, measuring, monitoring and controlling country and transfer risks, tailored to the size and complexity of their international exposures. The framework may include a system for risk assessment of countries, tolerance limits and monitoring with responsibility and accountability at various levels so as to facilitate effective management of exposures at the individual borrower, country and portfolio levels. The policy framework should be comprehensive enough to capture all significant exposures and detailed enough to permit adequate analysis of different types of risk.

5. Banks should have internal country risk exposure limits linked either to their Net Worth or Total Assets, as they deem fit, for different risk categories. Banks should also have contingency plans in place to deal with sudden changes in macro-economic and political conditions at the global level or specific regions or countries and have clear exit strategies to moderate the magnitude of country risk exposures.

6. The policy should mandate strict KYC principles of the cross-border borrowers, which should not be compromised by the backing of collateral or maturities of loans.

7. Management of country risk should also incorporate stress testing as one method to monitor actual and potential risks. Stress testing should include an assessment of the impact of alternative outcomes to important underlying assumptions.

#### **Measurement and Monitoring:**

8. Banks should reckon both funded and unfunded exposures from their domestic as well as foreign branches while identifying, measuring, monitoring and controlling country risk. In the case of the branches of foreign banks operating in the Sultanate of Oman, the scope would be confined to their branches in Oman. Local banks having overseas operations need not reckon their exposures on home country. An

illustrative list of funded and unfunded exposures that should be reckoned for measuring cross-border exposures is furnished below:

Funded Exposures	Unfunded Exposures
<ul style="list-style-type: none"> <li>• Cash balances</li> <li>• Bank balances</li> <li>• Deposit placements</li> <li>• Investments</li> <li>• Loans &amp; advances</li> <li>• Trade credits/receivables</li> <li>• Overdraft in Vostro Account</li> <li>• Remittances honoured under drawing arrangement</li> <li>• Other monetary assets</li> </ul>	<ul style="list-style-type: none"> <li>• Letters of Credit</li> <li>• Committed lines of credit</li> <li>• Guarantees</li> <li>• Performance bonds, bid bonds, warranties</li> <li>• Confirmation of LCs issued by foreign banks</li> <li>• Commitments undertaken against the counter-guarantees of foreign banks</li> <li>• Foreign Exchange Contracts and Derivatives (current and potential exposure)</li> <li>• Other off-balance sheet exposures</li> </ul>

9. In respect of foreign exchange contracts and derivatives, exposure may be computed by reckoning the current exposure and potential future exposure. Further, commitments that are unconditionally cancelable at any time by the bank without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness, need not be reckoned for the risk assessment.

10. The claims should be allocated according to the residence of the borrower/ operations of the unit. Legally binding guarantees from a resident of a country other than that of the borrower may be considered. Eligible collateral available in a country other than that of the borrower may also be considered in the same manner as guarantees. In such cases, the exposures could be moved to the country of the guarantor and the location of the collateral.

11. Exposure to a country may be considered as *significant* where the exposure is 1% or more of the total assets and off-balance sheet exposure of a bank. For such significant exposures, banks should have more detailed assessment and monitoring framework.

12. Banks should also take into account *indirect* country risk. For example, exposures to a domestic commercial borrower with large economic dependence on

a certain country may be considered as subject to indirect country risk. Indirect exposures may be reckoned at 50% of the exposure for the purpose of these guidelines. For the present, only in respect of countries where the exposure is *significant*, a bank is required to reckon indirect country risk exposures for measuring, monitoring and controlling the country risk.

13. Banks should have sound and well-defined credit-granting criteria and systems for monitoring the credit quality of individual loans and country-wise exposures in the portfolio. Banks should also perform their own independent credit risk analyses and review of terms while participating in syndicated cross-border exposures. In respect of inter-bank or other exposures that are covered by netting agreements, the legal basis should be sound and enforceable.

14. Banks are encouraged to use sound analytical techniques, such as internal credit rating for measuring the full dimensions of risks inherent in country exposures. The techniques should help analyse the risk at the portfolio level as well. The rating system should also factor the linkages between credit and market risks and its impacts on default probabilities of borrowers. The internal ratings should be mapped with those of the international rating agencies and the spirit should be that the internal ratings assigned to a country and / or a borrower should in no way be better than the ratings awarded by rating agencies.

15. In the absence of internal assessment of country risk, banks may use the ratings awarded by the External Credit Assessment Institutions (ECAIs), approved by the Central Bank for capital adequacy purposes.

16. The Central Bank encourages the banks to review their country risk exposures in the light of the above and to exercise due care in assuming fresh exposures, particularly in respect of countries which may come under 'restricted credit / off-credit' category or countries which are not rated by rating agencies.

**Provisioning for country risk exposures:**

17. Currently, banks have been directed to build general loan loss provisions on performing loans to meet the expected losses, while a graduated level of specific provisions have been mandated on non-performing loans. As regards exposures of banks to country and transfer risks, at present, no minimum provisioning requirement is being mandated by Central Bank. However, banks are encouraged to build adequate general loan loss provisions for meeting the expected losses arising out of country risk exposures and such general loan loss provisions should ideally be determined on the basis of country ratings, credit ratings and the associated default probabilities, loss given defaults, rating migrations, current macro-economic environment and other pertinent indicators. The position would be reviewed by

Central Bank after examining the nature and extent of such exposures of banks for considering the appropriate level of provisions, in due course. The Central Bank may also consider prescribing a prudential aggregate country exposure limit or a higher level of provisioning for the higher risk categories in respect of any bank where the exposures are observed to be excessive and / or the risk management systems are not commensurate to the level and complexity of the country risk exposures. A brief account of the important features of country risk regulations in some of the international jurisdictions is provided in the Attachment-2.

18. General loan loss provisions made *voluntarily* by banks for meeting the expected losses arising out of country risk exposures would be allowed to be included in Tier II capital as part of general provisions within the overall ceiling of 1.25% of total risk weighted assets.

**Review of policy and exposures:**

19. The policies along with strategies of the bank as regards country risk exposures should be reviewed by the Board of Directors periodically to factor the evolving risks. The frequency of periodic reviews of country risk ratings should be at least once a year with a provision to review the rating of a specific country, based on any major events in that country, where exposure is high, even before the next periodical review of the ratings is due. The Board should review the position of country risk exposures at least on a half-yearly basis and more frequently depending upon a bank's strategy and level of exposure. In case, any significant deterioration takes place in respect of exposure to any particular country or overall exposure, banks should report to the Board such developments in its next meeting, without waiting for the periodical review by the Board.

20. Country risk management processes employed by banks would require adequate internal controls that include audits or other appropriate oversight mechanism to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits.

**Reporting of country risk exposures:**

21. All licensed commercial banks operating in the Sultanate should report details of their country risk exposures to the Banking Surveillance Department of Central Bank of Oman on a quarterly basis in the attached format starting from quarter ended December 2006 and the reports are to be submitted within one month from the reporting date.

**Disclosure of country risk exposures:**

22. Banks should disclose the aggregate country risk exposures together with the aggregate provisions (voluntarily set aside) in the annual financial statement for providing transparency.

23. Banks may confirm, implementation of the guidelines at the earliest, and in any case within a period of six months.

Best regards

**Hamood Sangour Al-Zadjali**  
**The Executive President**

Enclosure: Attachment 1 - Reporting format  
Attachment 2 – A brief account of important features of country risk regulations at some of the international jurisdictions

**Exposures to Country & Transfer Risks**

Position as at the end of March/June/ September/ December 200X

**Bank Name:**

**Name of the Rating agency/ies:**

Amt. RO.000's

Sl. No.	Countries	Country Ratings	Gross Exposures								Net Exposures							
			Un-funded Exposure								Un-funded Exposure							
			Funded exposures		Credit Contingents		Contracts and derivatives		Total exposure		Funded exposures		Credit Contingents		Contracts and derivatives		Total exposure	
			Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days	Mat. < 180 days	Mat. > 180 days
1	Country 1																	
2	Country 2																	
3	Country 3																	
	...																	
	...																	
	Country 20																	
	All other countries - rated																	
	All other countries - unrated	-----																
	Total																	

**Authorised Signatory**

**Note:**

- (i) Significant exposures, which exceed 1% of total assets and off-balance sheet exposures, only need to be reported separately, upto first 20 countries. All other exposures may be clubbed together as a residual entry (either as 'all other countries rated' or 'all other countries unrated')
- (ii) Net exposures are to be arrived at after netting all available provisions for the exposures as also eligible cash collaterals, which are not subject to country risk
- (iii) All exposures need to be provided under segregated categories of "Maturity Less than 180 days" and "Maturity more than 180 days", on the basis of **original maturity** of the exposures.
- (iv) Contracts and Derivatives are to be reported on the basis of current exposure + potential future exposure method
- (v) The report should include the indirect country risk exposures, in terms of para 12 of the Circular.
- (vi) When a country rating differs between different ECAs or when the ECA risk score for that particular country does not fall into the same bucket, lowest rating (or the highest risk score) may be used.

**A brief account of important features of country risk regulations at some of the international jurisdictions**

**1. Practices in USA**

- Formal country risk management framework
- Provisioning not mandated but multinational banks invariably provide for country risk under ALLL (Allowance for Loan and Lease Losses); Small banks also provide for country risk under ALLL.
- Small local banks set aside provision for country risk under a less formal framework

**2. BAFIN (Federal Financial Supervisory Authority), France - 2005**

- Formal framework for country risk management
- Country risk provisioning on the basis of internal criteria/internal valuation
- Separate analysis /monitoring where the exposure is significant

**3. Dutch Supervisory Authority**

- Formal framework for assessment and monitoring; capital and provisioning requirement for country risk exposure
- Four categories (nil, low, medium and high) ; Low and medium category – Country having significant country risk but no acute repayment problem; High category – Country having acute threat of repayment problem
- No provisioning for 'Nil' risk category; Capital requirements as add-ons to the risk weights for credit risk on net exposures in respect of 'Low' and 'Medium' category; In respect of 'High' risk category, banks shall make adequate provisions on the basis of expected risk losses; Each bank should be able to prove the adequacy of its provisioning.

**4. Swiss Bankers Association (1997)**

- All exposures (banking book and trading book) are reckoned while the provisioning requirement may be different
- Value adjustments for the exposures on the basis of sound value principles; Provisioning against future unexpected losses on the basis of internal risk models (on the basis of internal and externally available ratings)
- The guidelines envisage that the regulator's minimum requirement has to be ensured.

**5. Hongkong Monetary Authority (HKMA)**

- HKMA guidelines envisage a proper policy/monitoring framework for country risk
- Provisioning on the basis of internal estimate by banks to be reviewed by auditors
- Provisions for country risk not included in the capital base
- Acceptable guarantees allowed in risk transfer
- Conservative approach in respect of un-drawn commitments

**6. Reserve Bank of India**

- Formal framework for assessment, monitoring and provisioning for country risk exposures
- Only in respect of the country, where a bank's net funded exposure is 1 per cent or more of its total assets, the bank is required to make provision for dealing with that country risk exposure.
- Seven category classification followed by Export Credit Guarantee Corporation of India Ltd. (ECGC) used for the purpose of classification and making provisions for country risk

**7. State Bank of Pakistan (SBP)**

- SBP envisages a formal assessment/monitoring framework. However, no provisioning for country risk is recommended
- Reliance on country ratings by external agencies for assessment for country risk

**8. Cayman Islands Monetary Authority (CIMA)**

- Formal country risk framework
- Adequate provisioning should be allocated on the basis of internal assessment (on the basis of their probability of losses) subject to review by auditors and CIMA for adequacy of provisions
- Banks are advised to follow a conservative approach in respect of undrawn commitments
- Country risk provisioning not included in the capital base

**9. Central Bank of Bahamas (2006)**

- Detailed formal country risk management framework envisaged
- Country risk provisions on the basis of internal assessments should be set aside to cover the potential losses from country risk exposure.
- Central Bank to review the adequacy of provisioning

**10. Central Bank of Montenegro (December 2004)**

- Formal policy framework and mandate for allocation of reserves and provisions based on country risk exposures; Provisioning as under:

Rating	Provision (%)	Rating	Provision (%)
BBB and better	0%	CCC+	30%
BBB-	2	CC+, CC, CC-	50%
BB+ and BB	5%	C+, C, C-	75%
BB-, B+, B	10%	DDD	100%
B-	20%		

- Long term credit rating of countries by external agencies may be used
- (i) Shares/debentures in AFS/HFT, (ii) OBS if they are cancelable anytime, and (iii) Amount of receivable for which hedging of risk is performed, etc., are not to be included in country risk exposure

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